No. 14689

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

The Vita-Food Corporation,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONER'S OPENING BRIEF.

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Jurisdiction.

This proceeding involves determination of federal income, declared value excess-profits, and excess profits taxes for the year of petitioner ended October 31, 1943. [R. 27.] The jurisdiction of this Court is based on sections 1141 and 1142, I.R.C. 1939, as continued in effect by section 7851(b)(1), I.R.C. 1954. The jurisdiction of the Tax Court was based on section 272, I.R.C. 1939.

The notice of deficiency was issued September 16, 1952. [R. 9.] On December 9, 1952, petitioner filed a petition in the Tax Court of the United States. [R. 1.] The Tax Court's decision was entered January 21, 1954. [R. 3.] On January 27, 1954, petitioner filed its petition for review herein. [R. 3.]

Petitioner is a California corporation and has its principal place of business in Los Angeles, California. Petitioner's federal income, declared value excess-profits, and excess profits tax returns for the year involved herein were filed with the Collector of Internal Revenue for the Sixth District of California. [R. 29.]

Questions Presented.

1. Whether the Commissioner erroneously disallowed deduction of $22,511.03 in respect of compensation paid M. H. Lewis for the year ended October 31, 1942, and $20,320.00 in respect of compensation paid him for the year ended October 31, 1943. In connection with the amount for the year ended October 31, 1942, there is also the question whether the Tax Court had jurisdiction to make a determination in respect thereto, although such determination was necessary for determination of carrybacks from the year ended October 31, 1944, to the year ended October 31, 1943.

2. Whether the basis for determining gain on the good will and trade-mark sold by petitioner to The Stuart Company on November 28, 1942, included the cost to petitioner of the good will it purchased from Lewis on February 4, 1941.

3. Whether the Commissioner carried his burden of proof in connection with the increase of deficiency requested by him in amended answer based on disallowance of the portion of cost of such good will allowed by him in the deficiency notice.

4. Whether $75,000.00 out of the total of $200,000.00 received by petitioner from The Stuart Company under a settlement agreement entered into November 28, 1942,

was capital gain because received for the good will and trade-mark sold under said agreement to The Stuart Company, or ordinary income because paid to petitioner for cancellation of the distributorship contract between petitioner and The Stuart Company.

Statement.

Because of the several issues involved and the fact that much of the argument consists of analysis of the facts, this statement is in the nature of a general outline. The details are filled in, with citation to the record, in the argument under each issue.

Petitioner was organized November 28, 1940, under the laws of California. [R. 29.] One Maxwell H. Lewis was chiefly responsible for its organization. [R. 29.] In 1939 and 1940 he was engaged in certain nutritional studies, and thereafter he decided to go into the business of manufacturing vitamins. [R. 29-30.] He began operation as an individual during the summer of 1940. [R. 30.] During October or November, 1940, and prior to the formation of petitioner, he entered into negotiations with one Arthur Hanisch, a multimillionaire, and reached a general understanding for exclusive distribution by him. [R. 31-33.] Pending completion of details petitioner was formed, on November 28, 1940 [R. 33-34], for the purpose of taking over Lewis's end, the manufacturing end, of this deal with Hanisch. [R. 103-105.]

The arrangement between Lewis and Hanisch was first put into written form on February 4, 1941. [R. 34-35.] Lewis did this in the name of petitioner instead of in his own [R. 34] in order to transfer the deal to

petitioner. [R. 103-105.] On the same date stock was first issued by petitioner [R. 36], and on that date also Lewis sold to petitioner, for a specified price, non-exclusive manufacturing rights in the formulas and products he had developed [R. 44-45], together with all of the good will attached to such products and acquired by Lewis in connection with them. [R. 44-45.] All of these things which occurred on February 4, 1941, including the deal with Hanisch and the transfer of rights and good will to petitioner, were a single "package." [R. 103-105.]

Subsequently the tradename "The Stuart Formula" became attached to the product sold by petitioner, that product being sold to a corporation organized by Hanisch for the purpose, The Stuart Company. [R. 112.] The Stuart Company in turn sold the product to drug stores, hospitals, et cetera. [R. 47-48, 95-97.] On May 5, 1941, the deal with Hanisch was restated and elaborated in a comprehensive written agreement with Hanisch and The Stuart Company. [R. 35, 55.] Pursuant to that agreement with Hanisch and The Stuart Company all trade names were and remained the property of petitioner. [R. 47.]

Conflicts later arose between Lewis and Hanisch. Hanisch, in particular, wanted a stock interest in petitioner, but Lewis refused. [R. 59-60.] The conflicts were resolved by a sale by petitioner to The Stuart Company, on November 28, 1942, of petitioner's good will and its trade-mark, "The Stuart Formula." [R. 48, 110-111.] The total consideration paid petitioner was $200,000.00. [R. 69.] Petitioner had paid Lewis for the good will transferred to it on February 4, 1941, the sum of

$78,200.95. [R. 45.] Additional charges brought the basis of that asset up to $78,350.95. [R. 48.]

Lewis was vice-president, treasurer and managing director of petitioner with authority to exercise all the powers of president. [R. 37.] He was also sales manager. [R. 37.] He directed all of petitioner's activities, working an average of 12 hours per day. [R. 98.] He received compensation of $42,511.03 for the year ended October 31, 1942, and $39,783.03 for the year ended October 31, 1943. [R. 40.] As redetermined by the Tax Court petitioner, during its first three years, the years ended October 31, 1941, 1942 and 1943, accumulated net earnings of $66,523.87, after all charges, including Lewis's actual compensation and all federal taxes, an average of 66% per year on its maximum invested capital of $33,152.00. [R. 80-81.]

The Commissioner disallowed deduction of $22,511.03 of the compensation paid Lewis for the year ended October 31, 1942, and $20,320.00 of the compensation paid him for the year ended October 31, 1943. [R. 40, 12.] The Commissioner disallowed three-fourths of the cost of the good will purchased by petitioner, in determining the basis of the good will and trade-mark sold to The Stuart Company. In the Tax Court, at the time of trial, the Commissioner contended that the other one-fourth should also be disallowed, contending that the items sold The Stuart Company had no cost at all. [R. 25, 49.] The Commissioner also treated $75,000.00 out of the $200,000.00 received by petitioner for the good will and trade-mark as ordinary income, contending that that amount was paid for settlement of the contract between

petitioner and The Stuart Company. [R. 15.] Petitioner had reported the entire gain as capital gain. [R. 15.]

The Tax Court sustained the salary disallowance for the year ended October 31, 1943. It made no finding as to what reasonable compensation was for that year, but based its decision solely on the ground that it was "unable to find that the respondent erred." [R. 44.] It made no determination in respect to the compensation for the year ended October 31, 1942, holding that, the Commissioner having asserted no deficiency for that year, it had no jurisdiction [R. 41-42]—this despite that (1) the deficiency notice showed a net operating loss carry-back from the year ended October 31, 1944 [R. 13], (2) the deficiency notice also showed an unused excess profits credit carry-back from the same year to the year ended October 31, 1943 [R. 18-19], and (3) because of the two-year carry-back provisions the net income and excess profits net income for the year ended October 31, 1942, had to be determined in order to determine the carry-backs from the year ended October 31, 1944, available for deduction in the year ended October 31, 1943.

As to the basis of the trade-mark and good will sold to The Stuart Company, the Tax Court also sustained the Commissioner. [R. 53.] The Tax Court further sustained the Commissioner in his treatment of the amount of $75,000.00, out of the consideration received on sale of the trade-mark and good will, as ordinary income instead of capital gain. [R. 73.]

Petitioner contends that the Tax Court erred in all of these respects.

Specifications of Error.

Petitioner specifies the following errors of the Tax Court:

1. The holding that it did not have jurisdiction to determine the amount allowable as a deduction for the year ended October 31, 1942, in respect of compensation paid M. H. Lewis in that year.

2. The failure of the Tax Court to determine that the Commissioner erred in disallowing the sum of $22,511.03, in respect of compensation paid M. H. Lewis in the year ended October 31, 1942.

3. The failure of the Tax Court to find that the Commissioner erred in disallowing the sum of $20,320.00 as a deduction for the year ended October 31, 1943, in respect of compensation paid M. H. Lewis in that year.

4. The failure to hold that the cost of the good will and trade-mark sold to The Stuart Company on November 28, 1942, was $78,340.95.

5. In respect of the one-fourth of said sum, or $19,585.24, allowed by the Commissioner in his deficiency notice, and thereafter asked by him, by amended answer, to be disallowed, the failure to hold that the Commissioner did not carry his burden of proof.

6. The failure to hold that no part of the $200,000.00 received by petitioner from The Stuart Company under an agreement dated November 28, 1942, was ordinary income instead of capital gain.

Summary of Argument.

I.

In order to determine the taxes for the year ended October 31, 1943, it is necessary, because of carry-backs from the year ended October 31, 1944, to make a determination of the net income for the year ended October 31, 1942, as the Tax Court did in its decision. The Tax Court had express statutory jurisdiction to make this determination and therefore also had jurisdiction to determine the amount allowable as a deduction for salary of M. H. Lewis for that year.

The compensation paid Lewis and deducted by petitioner did not exceed a reasonable allowance for the services rendered by him. No services performed by Lewis after 1942 were involved in the amounts disallowed by the Commissioner and the considerable evidence of services rendered in the years 1941 and 1942, as found by the Tax Court, was wholly uncontradicted and cannot be ignored by the Tax Court. Furthermore, the Commissioner's determination in respect of the compensation paid Lewis is inconsistent with the totality of his determination in respect to net income. Therefore no presumption of correctness attaches to his determination.

To the contrary, the amounts of compensation paid here are presumptively reasonable; they were voted by the Board of Directors at the beginning of each year before the profits were known, and the bulk of the compensation was contingent. Further, the qualifications of Lewis, the actual services he rendered, the results accomplished by him in terms of earnings of petitioner, all sustain the compensation paid. There is no support in the record for the suggestion that Lewis was not re-

quired to devote his full time to the business after January 1, 1943. As to the item of $7,820.00 paid Lewis as commission, the record does show special services rendered in connection with the sale of the trade-mark, "The Stuart Formula," supporting the reasonableness of the payment.

II.

In order to determine the amount of taxable proceeds of the sale of good will and trade-mark to The Stuart Company by petitioner, there must be deducted the cost to petitioner of the good will which it acquired from Lewis on February 4, 1941. This good will did in fact exist. It consisted of the acceptance of the product by hospitals and physicians and by a distributor, Hanisch, who had already undertaken its nationwide distribution and paid in advance for a large initial order. It is clear also as a matter of law that the existence of good will on February 4, 1941, was not dependent upon the existence of profits prior thereto.

When Lewis transferred the good will to petitioner, he also transferred the business with which it was connected, the manufacturing and formula rights in products he had developed, and the business deal with Hanisch. This good will attached itself to and became a part of the trade-mark, "The Stuart Formula." When the trade-mark was sold to The Stuart Company, the good will Lewis sold to petitioner passed with it, necessarily and also by express assignment.

The trade-mark "The Stuart Formula," derived its original value from the good will which Lewis conveyed to petitioner, and the development of this good will by The Stuart Company was by a distributor acting as such and therefore belonged to the manufacturer.

Since only the excess of the amount realized over the cost is gain, which alone may be taxed, the cost of the good will to petitioner must be deducted in arriving at the amount to be included in gross income in respect of the sale by petitioner of good will and trade-mark to The Stuart Company.

III.

In no event should the portion of the good will cost allowed in the deficiency notice have been disallowed by the Tax Court, because the Commissioner failed to carry his burden of proof, as required by the Rules of Practice. In fact there was no finding at all that the good will and trade-mark had no cost or other basis.

IV.

The entire amount of $200,000.00 received by petitioner under the settlement agreement of November 28, 1942, with The Stuart Company represented the proceeds of sale of good will and trade-mark. That sum, to the extent of the excess over cost, was capital gain, because it was paid for a capital asset; no part of it was ordinary income.

The contract of May 5, 1941, under which petitioner granted to The Stuart Company exclusive distributorship of the product sold under the name of "The Stuart Formula," was cancelled by notice served by petitioner on October 8, 1942, accepted by Stuart on October 12, 1942, and ratified by petitioner's Board of Directors on October 23, 1942. Petitioner sought and obtained a temporary restraining order against use of the trade-mark, "The Stuart Formula," by The Stuart Company, in litigation filed on November 25, 1942. This litigation was settled by transfer for consideration of the trade-mark

and good will from petitioner to The Stuart Company. The consideration was not for cancellation of the contract which was no longer extant.

In any case, when The Stuart Company, the exclusive distributor, acquired from the manufacturer the trade-mark under which the product was sold, and the good will of the business, the distributorship was merged with the trade-mark and ceased to exist. Under the cases the entire sum so received for the sale of the good will and trade-mark represents the proceeds of sale of a capital asset.

ARGUMENT.

I.

The Tax Court Erred in Failing to Allow Deduction of the Amounts Disallowed by the Commissioner, in Respect of Compensation Paid by Petitioner to M. H. Lewis in the Years Ended October 31, 1942 and October 31, 1943.

A. The Tax Court Had Jurisdiction of the Issue of Deduction for the Year Ended October 31, 1942, Relating to Compensation Paid M. H. Lewis in That Year.

Section 272(g) of I. R. C. 1939 (App. herein, p. 2) expressly gives the Tax Court jurisdiction to determine facts with relation to any year where such determination is necessary to a determination of the taxes for the taxable year involved. The taxable year involved here, that is, the year for which a deficiency was determined by the Commissioner, is the year ended October 31, 1943. If then in order to determine the taxes here for the year ended October 31, 1943, it is necessary to make a determination of the net income for the year ended October 31, 1942, then the Tax Court had jurisdiction to de-

What is more, the Tax Court, in its very decision herein in respect of taxes for the year ended October 31, 1943, took into account the net income for the year ended October 31, 1942, the thing which it said it could not do. The above figure of $3,983.96 for "Adjusted excess profits net income for the year ended 10/31/42" appears in the recomputation of tax for the purpose of that decision, specifically in arriving at the balance of excess profits credit carry-back "available as carryback to year ended 10/31/43." [R. 79.] Thus even the Tax Court in its very decision denying jurisdiction over the year ended October 31, 1942, was compelled to take the net income for that year into consideration in determining the taxes for the year ended October 31, 1943.

It must follow that the Tax Court had jurisdiction to determine the net income for the year ended October 31, 1942, and therefore to determine the amount allowable as a deduction for salary of M. H. Lewis for that year.

B. Of the Compensation Paid M. H. Lewis in the Year Ended October 31, 1943, Only Compensation for Services Rendered Prior to 1943 Is Involved in This Proceeding.

The Tax Court's findings show four separate items of compensation paid M. H. Lewis in the year ended October 31, 1943. The first two of those items, "Base salary" in the amount of $7,200.00 and "Commission" in the amount of $12,263.03 [R. 40], or a total of $19,463.03, were allowed by the Commissioner. [R. 41.] Only the remaining two items, labeled "Income Taxes" in the amount of $12,500.00 and "Additional" in the sum of $7,820.00 [R. 40], or a total of $20,320.00, were disallowed. [R. 41.]

As to the first of those items, $12,500.00, the fact that it was in form of reimbursement of income taxes is, of course, immaterial. Payment of employees' income taxes is treated for tax purposes just like other forms of compensation. (*Old Colony Trust Co. et al. v. Commissioner,* 279 U. S. 716 (1929); *Levey v. Helvering* (C. A., D. C.), 68 F. 2d 401 (1933); *Mary Sachs v. Commissioner,* 11 T. C. M. 882, 889 (1952).)

That item of $12,500.00 was paid Mr. Lewis, under the compensation formula approved by the directors, in respect of 1942. [R. 112.] A similar item, in the amount of $8,075.26, had been paid him in petitioner's year ended October 31, 1942 [R. 40], in respect of 1941. [R. 111-112.] The latter item had been included by him in his 1941 return, and the $12,500.00 item for 1942 was included by him in his 1942 return. [R. 111-112.] No such allowance was made after the calendar year 1942. [R. 112.] The item of $12,500.00 for 1942 had no relation to any period after that year except for the fact that petitioner was on a fiscal year basis, with a year ending October 31, so that the amount was accrued and deducted by petitioner in its fiscal year ended October 31, 1943.

The same fact is true of the item of $7,820.00. As the findings show, that amount was paid to Mr. Lewis as a commission on the sale of "the Stuart Formula" trademark. [R. 40.] That sale took place November 28, 1942. [R. 48.] Thus the item of $7,820.00 was compensation for services rendered in 1942. No services after that year were involved.

C. The Tax Court Has Indicated That a Proper Showing Was Made in Respect of Lewis's Services Prior to 1943, So That Deduction for the Compensation Paid Him for Periods Prior to 1943 Should Have Been Allowed.

The Tax Court states in its opinion that "petitioner submitted considerable evidence as to the services performed by Lewis for the fiscal years 1941 and 1942 and the amount of time devoted by him to the petitioner's business in those years." [R. 42.] What the Tax Court meant was the *years* 1941 and 1942, not the *fiscal years* 1941 and 1942. The evidence that was introduced as to the services performed by Lewis and the time put in by him covered the *years* 1941 and 1942, and not any *fiscal years.* [R. 98, 99.] Of course, since as shown under "B" above no services after 1942 were involved in the amounts disallowed by the Commissioner, no evidence in respect of services after 1942 was necessary.

The Tax Court was right in pointing to the "considerable evidence" of services rendered and time put in. It is not the title of the office held but the actual services rendered which govern. *Smokey Mountains Beverage Company v. Commissioner,* 22 T. C. No. 156 (1954), where the court stated:

> "But section 23(a)(1)(A) provides for the deduction of compensation paid for personal services actually rendered. It contains no requirement that the services performed coincide with the general understanding of the duties of the office held."

To the same effect:

Amco Investment Co. v. Commissioner, 4 T. C. M. 307, 309;

4 Mertens, Law of Federal Income Taxation, Par. 25.53.

The "considerable evidence" of services rendered and time put in referred to by the Tax Court was wholly uncontradicted. Nor was any countervailing evidence introduced by respondent based upon a showing of the services rendered and time put in by any other person. In that respect the record made by petitioner is completely unchallenged. In *Loesch & Green Construction Co. v. Commissioner* (C. A. 6), 211 F. 2d 210 (1954), the court, quoting cases decided by Courts of Appeals of the 5th, 6th and 10th Circuits, held that where evidence introduced by the taxpayer on the reasonableness of salaries is "unimpeached, competent, relevant and uncontradicted," the taxpayer's burden is met and, further, that the "Tax Court cannot reject or ignore this evidence and determine the propriety of the amount of salaries paid upon its own innate conception of reasonableness." The deduction here for compensation paid Lewis for services prior to 1943 should therefore have been allowed.

D. The Compensation Paid Lewis in the Years Involved Herein and Deducted by Petitioner Did Not Exceed a Reasonable Allowance for Services Rendered by Him.

(a) *Statutory Provision and Amounts of Compensation Involved.*

The statute, I. R. C. 1939, Section 23(a)(1)(A), (App. herein, p. 1), provides for deduction of a "reasonable allowance for salaries or other compensation for personal services actually rendered."

The compensation involved here is that paid in the taxable years ended October 31, 1942, and October 31, 1943, to M. H. Lewis, petitioner's executive vice-president, treasurer, managing director, sales manager, and only officer during those years on a full-time basis. The

totals paid officers in those two years were $49,861.03 and $45,783.03, respectively, and of those amounts the amounts paid Lewis were $42,511.03 and $39,783.03, respectively. For the earlier year the Commissioner reduced the deduction for compensation paid Lewis to $20,000.00, disallowing the remainder of $22,511.03; and for the later year he reduced the deduction to $19,463.03, disallowing the remainder of $20,320.00. [R. 40, 12.] As shown under "B" above, the amount disallowed for the later year consists of two items paid in respect of services rendered by Lewis during the calendar year 1942, so that the disallowance for the taxable year ended October 31, 1943, as for the taxable year ended October 31, 1942, relates to services rendered prior to January 1, 1943.

(b) *The Rule Which Ordinarily Invests the Commissioner's Determination With a Presumption of Correctness Does Not Apply in This Case, Because That Determination Was Itself Inconsistent; in Fact, the Very Opposite Is True Here—the Amounts of Compensation Involved Here Are Presumptively Reasonable, Because They Were Voted by Petitioner's Directors, and at the Beginning of Each Year.*

The record is devoid of any indication of the basis upon which the Commissioner determined that the amount which he allowed was reasonable. In fact, the Commissioner's determination on that issue is inconsistent with the totality of his determination in respect to net income. Thus, for the year ended October 31, 1943, the Commissioner cut the allowance for salary paid Mr. Lewis and yet increased net income to $125,437.48 [R. 15], which, after allowing for taxes of $50,068.34 on the

increased net income,* leaves net earnings of $75,369.14, a return of 227% on stockholders' investment of $33,-152.00. [R. 36.] That the percentage of earnings on stockholders' capital is a basic factor in determining reasonableness of salaries will be shown more fully below. The point here is that there is an inconsistency on the face of the deficiency letter in reducing, without explanation, the salary of petitioner's principal officer and at the same time asserting a net income which results in earnings, after taxes, of 227% on stockholders' investment.

"In tax cases the burden of proof is measured by the deficiency letter." (*Lenox Clothes Shops, Inc. v. Comm.* (C. A. 6), 139 F. 2d 56 (1943).) The deficiency letter is the Commissioner's determination (I. R. C. 1939, Sec. 272(a)(1)); and where that determination is itself inconsistent, it cannot be given effect. (*Gasper v. Commissioner* (C. A. 6), ... F. 2d ...... (July 6, 1955).) Therefore no presumption of correctness attaches to the Commissioner's determination in this case.

Here, indeed, the very opposite is the situation. The salaries here were voted by the directors, and at the beginning of each year, before the year's profits were known. [R. 99, 37.] Action of the directors, at any time, creates a presumption of reasonableness. In *Ox Fibre Brush Co. v. Blair* (C. A. 4), 32 F. 2d 42 (1929), affirmed 281 U. S. 115, 50 S. Ct. 273 (1930), the Court of Appeals for the Fourth Circuit stated, at page 45:

> "The action of the board of directors of a corporation in voting salaries for any given period is en-

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*$40,821.03 [R. 11] being the total tax on net income of $115,-162.69 [R. 15], plus 90% of $10,274.79 [R. 15], or a total of $50,068.34.

for the services for which he was paid. That point is supported by a long list of cases. Mertens, Volume 4, Paragraph 25.52, cites 56 such cases.

Judged from the standpoint of that factor Lewis stands high. He was eminently qualified for the services which he rendered. In 1940, when petitioner was formed, he was 43 years of age. [R. 117.] He had held executive positions in government fields involving health and nutrition, with the expenditure of 10 million dollars a month of state and federal funds under his supervision, and with a staff numbering from 60 to 1,800 under his immediate direction and supervision. [R. 100-101, 118-120.] Dr. Henry Borsook, an authority in the field of nutrition [R. 29], regarded Lewis so highly that he would trust no one else with the marketing of vitamins upon which he could place his stamp of approval. [R. 33.] Mr. Hanisch, respondent's witness, also agreed that Mr. Lewis was very able. [R. 161.] It must be borne in mind also in this connection that Mr. Lewis not only produced multiple vitamins—he pioneered the multiple vitamin industry. The Tax Court here itself found as facts:

> "About the middle of 1940, after completing his work with Dr. Borsook on the analysis of the nutritional requirements of the nation, Lewis went into the vitamin business. At that time vitamins were being sold individually and at high prices. Lewis' purpose, through the use of Dr. Borsook's formulas and standards as bases, was to produce a single mixed product containing in each dose all the known vitamin and mineral requirements for the human body which would sell at approximately one-tenth of the total of the then current prices for individual vitamins. *In this he succeeded.*" [R. 29-30.] (Italics added.)

(e) *The Actual Services Rendered by Lewis and the Time Put in by Him Show His Compensation to Be Reasonable.*

A further basic factor is Lewis's services—not just his title or his formal designation, but his actual responsibility and his actual work. Here also, the cases are legion. Indeed, without a showing of the actual duties performed and time put in by the officer involved a court could make no determination of reasonableness. 4 Mertens Par. 25.53 (citing, n. 6, 71 separate cases).

The Tax Court states that the evidence introduced by petitioner on this issue was "considerable." [R. 42.] It was, indeed, considerable. Mr. Lewis put in an average of 12 hours a day. [R. 98.] He directed all of petitioner's activities, including its manufacturing. He purchased all of its supplies, hired its employees and took care of its financing. [R. 98.] He prepared telephone sales talks [R. 108], and the content and technical presentation of all of its advertising material. [R. 107, 127, 161.] In general he directed petitioner's advertising, promotion, and marketing program. [R. 107, 127.] He also served as an officer of The Stuart Company [R. 59], petitioner's sole distributor, without additional compensation. [R. 99.] Clearly he was the heart and substance of petitioner's activities.

(f) *The Results Accomplished by Lewis for Petitioner, in Terms of Earnings of Petitioner, Sustain the Compensation Paid Him.*

We come next to the question of results. Results can be precisely measured. The end result of business activities is earnings, earnings remaining on shareholders' investment, after deduction of all expenses, including

compensation of officers—and on the basis of such earnnings the reasonableness of specific amounts of compensation can be determined.

Here in the period of 10 months ended October 31, 1941, petitioner's very first period, with a capital invested of only $100.00, petitioner had a net income of $16,280.00 [R. 40.] According to the Commissioner's computation, and as determined by the Tax Court, during the two years and ten months ended October 31, 1943, with capital invested $33,152.00 at its highest point [R. 36, 80], and after all deductions, *including the disallowed salaries, and all income and excess profits taxes as computed after such disallowance,* a surplus of $62,523.87 was accumulated [R. 81], or 66% per year on maximum shareholders' capital. Highlighting this very point the Tax Court here states, in connection with another issue, that

> "petitioner, with only a comparatively small capital, was, and had been, operating at a profit after payment to its managing officer of compensation of approximately $40,000 a year." [R. 71.]

This was an amazing accomplishment for a new corporation. The development period of a business is normally associated with losses, not profits. As the regulations issued under the relief provisions of the World War II excess profit tax law state (Regulations 112, Sec. 722-3(d)):

> "Generally, business experiences a time lag between the time that new operations are commenced, reflecting either the starting of a new business or a business essentially different in character from an old business, and the attainment of a normal earning level."

To the same effect, Journal of the American Statistical Association, December, 1954, Page 847, Paragraph 9d, where it is stated:

> "Business mortality. It is fairly well established that with most types of business the early years are the most difficult. It is then that mortality is highest. The longer a business survives, generally, other things being equal, the smaller becomes the probability of failure."

Even after they have passed the development stage businesses do not often reach the level of profit that was accomplished here at the very beginning. In numerous cases decided by the Tax Court itself in which the officers whose salaries were involved held 85% or more of the stock, and in which earnings left as a percentage of capital stock were the primary factor in sustaining the reasonableness of such salaries, those percentages were as low as 8% but never as high as 66%. See: *National Alloys Co.*, 7 T. C. M. 962 (1948); *Schaberg-Dietrich Hardware Co.*, 6 T. C. M. 269 (1947); *Charles Schwartz & Co.*, 4 T. C. M. 841 (1945); *Benz Brothers Co.*, 20 BTA 1214 (1930); *Woodruff Lumber Co.*, 6 BTA 515 (1927); *Law and Credit Co.*, 5 BTA 57 (1926).

In *Lucas v. Ox Fiber Brush Co.*, 281 U. S. 115, 50 S. Ct. 273 (1930), the Supreme Court took note of that point as follows:

> "The net income in 1920, after a deduction of all expenses, including officers' salaries, represented a return of 21.13 per cent on invested capital of about $750,000, as determined by the Commissioner of Internal Revenue."

It is clear here that Lewis accomplished phenomenal results, in terms of earnings of petitioner, after all deductions, including his compensation and also federal taxes, and on that basis alone the compensation paid him was reasonable.

(g) *The Tax Court Misstates the Record in Suggesting That Lewis Was Relieved of Any Time or Duties During 1943.*

The Tax Court here says that during the period January 1 to December 31, 1943, there was "nothing to indicate that Lewis was not to continue free to engage in such personal activities as he wished and was to receive the agreed compensation so long as he devoted only 'a substantial portion' of his time to the affairs of the petitioner." [R. 43.] The point is not important since, as shown above, pages 14, 15, Lewis's compensation for any period after 1942 is not involved in this proceeding. Nevertheless, it may be observed that this statement of the court below is wholly without support in the record. The board resolution to which the Tax Court refers [R. 39] placed Lewis on the same basis verbatim as he had been in 1941, and the first half of 1942, when he was on a full-time basis and actually put in an average of 12 hours a day. The suggestion that he was not required to devote his full time after January 1, 1943, has no foundation in the record.

(h) *The Reasonableness of the Item of $7,820.00 Paid Lewis Is Sustained by the Record.*

In respect of the item of $7,820.00 paid Lewis, pursuant to action of petitioner's board of directors, as commission in connection with the sale of the trade-mark "The Stuart Formula," the Tax Court states that the record failed to disclose that under its agreement with Lewis, petitioner was under any obligation to make such payment. [R. 43-44.] No prior obligation is required, however, to support a deduction for additional compensation paid. (*Lucas v. Ox Fibre Brush Co., supra.*) The Tax Court here further says that "the reasons prompting the directors to authorize such payment are not disclosed." But the record does show the special services rendered by Lewis in connection with the sale of the trade-mark "The Stuart Formula." [R. 112-116, 133.] The sale price was $200,000.00. [R. 69.] Certainly here is a clear case of the inference of reasonableness, pointed out above, that attaches to authorization by the taxpayer's board of directors. (*Ox Fibre Brush Co. v. Blair, supra.*) There is no justification whatever for the Tax Court's position in regard to that item.

Against this background of fact and law the action of the Commissioner in disallowing a portion of the compensation paid Mr. Lewis was highly arbitrary. The record is wholly wanting in any justification for his action. We submit that the amounts paid Mr. Lewis should have been allowed in full.

II.

The Cost to Petitioner of the Good Will Which It Acquired From Lewis Must Be Deducted in Arriving at the Amount Taxable in Respect of the Sale of Good Will and Trade-mark to the Stuart Company.

A. The Good Will Which Lewis Conveyed to Petitioner on February 4, 1941, Did in Fact Exist.

As the Tax Court summarizes petitioner's description of that good will, it consisted of

> "Lewis's contacts with the California Institute of Technology and Dr. Borsook, their approval of the product he had developed and his price determinations and marketing practices; the approval and acceptance by hospitals and physicians of his product, though only in the form of test samples bearing no name but only numbers; and his contact with Hanisch and the latter's approval of the venture and his readiness to market the products." [R. 50.]

This description of the good will is fully supported by the record. [R. 29-35, 106-107.] As the Tax Court also stated, petitioner urged there that the good will so described became inseparably attached to the trade-mark "The Stuart Formula" and "the two became fused into a single property." [R. 50.] That fact, too, is fully supported by the record. [R. 95-96, 112, 145-146.] There is nowhere any suggestion of a finding to the contrary.

The good will so described was good will.

> "If a business is made valuable by the skill and attention of its creator the good will thus created is recognized by the law as property belonging to the founder and if, in connection with the business, he

adopts and publicly uses a trade-mark, he has a remedy either at law or in equity against those who undertake to use it without his permission."

American Dirigold Corporation v. Dirigold Metals Corporation (C. A. 6), 125 F. 2d 446, 452 (1942).

The Tax Court, however, in its opinion, and without any finding to that effect, takes the position that no good will existed in Lewis's vitamin business at the time he made the transfer of that good will to petitioner. [R. 52.]

As showing that no good will did in fact exist here, the Tax Court says first that the name "Buoyant B" was not acquired by petitioner and that therefore it parted with nothing when it agreed to discontinue that name "in order to obtain the agreement of May 7, 1941." [R. 51-52.] True, it did not acquire the name "Buoyant B," but that was because, as the Tax Court itself found, the discontinuance of "Buoyant B" was agreed upon between Lewis and Hanisch before petitioner was even formed. [R. 33-34.]

As a second point showing that no good will in fact existed, the Tax Court notes that Lewis realized no profits from his vitamin business prior to the transfer of good will to petitioner on February 4, 1941. [R. 52.] That point, to begin with, does not correctly reflect the law. In *Commissioner of Corporations and Taxation v. Ford Motor Company,* 308 Mass. 558, 33 N. E. 2d 318, 139 A. L. R. 936 (1941), the Supreme Court of Massachusetts stated, 139 A. L. R. at page 949:

"A Corporation may have a valuable good will even though the business may have been conducted

at a loss during certain years, Barden Cream & Milk Co. v. Mooney, 305 Mass. 545, 26 N. E. (2d) 324; Rookwood Pottery Co. v. Commissioner of Internal Revenue, 6 Cir, 45 F. (2d) 43, 45; Securities Realization Co. v. Peabody & Co., 300 Ill. App. 156, 20 N. E. (2d) 874; Appeal of C. F. Hovey Co., 4 B. T. A. 175, 177, . . ."

In the *Rookwood* case cited in the foregoing quotation, the Court of Appeals for the Sixth Circuit stated, at page 45:

"The decision of the board assumes that there could have been no good will if there had been no net profits. This is clearly wrong; many an enterprise has been, by its good will, sustained and carried through a non-profit period."

In *Macfadden v. Jenkins,* 40 N. D. 422, 169 N. W. 151, 156 (1918), it was held that good will may have a value although there have been no past profits. The distinction between "profits" and "good will" was shown in the case of *Nelson v. Hiatt,* 38 Neb. 478, 56 N. W. 1029, 1032 (1893), wherein the Court said:

"The distinction between the two [profits and good will] is obvious. Profits are the gains realized from trade; good will is that which brings trade. A favorable location of a mercantile establishment, or the habit of customers to resort to a particular locality, will bring trade. This advantage may be designated by the term 'good will.' What the trader gains from the trade so acquired are 'profits.' "

The Tax Court here was also wrong as to the facts. On February 4, 1941, when the good will was transferred to petitioner, a basis for profits had already been laid and

on that very date it was already bearing fruit. What is referred to is the contract whereby Hanisch, a multimillionaire [R. 31], agreed to undertake a nationwide distribution of Lewis's vitamin products, an agreement which had, prior to the formation of petitioner on November 28, 1940, reached the stage of "a general understanding as to terms and conditions" [R. 33], and which, by February 3, 1941, had resulted in a first order from Hanisch with a check from him for $23,510.40. [R. 34.] That first order and check were accepted February 3, 1941, by a letter summarizing the detailed agreement which had been reached between Lewis and Hanisch for the distribution of Lewis's vitamin products. [R. 34-35.] Lewis wrote that letter in petitioner's name instead of in his own in order to transfer his deal with Hanisch to petitioner. [R. 103-105.] On February 4, 1941, Hanisch replied to petitioner confirming the summarization contained in petitioner's letter of February 3, 1941, as representing the agreement arrived at between Lewis and Hanisch through their discussions. [R. 35.]

The good will which Lewis transferred to petitioner on February 4, 1941, was intended to and did include this customer relationship of Hanisch to petitioner [R. 103-105, 106-107], and it was out of this relationship that petitioner's profits were derived and it was as a result of this relationship that petitioner was able to develop the trade-mark "The Stuart Formula" and to sell it for $200,000.00. This good will, moreover, was not a mere product of Lewis's personal efforts alone. In developing it he expended, in cash, the sum of $8,200.95, and that was the cash cost of that good will to him. [R. 130.]

As it was stated by Mr. Justice Cardozo in *In re Brown's Will,* 242 N. Y. 1, 150 N. E. 581, 44 A. L. R. 510, 10A Mertens 71, 86 (1926):

> "Men will pay for any privilege that gives a reasonable expectancy of preference in the race of competition. *Cf.* Walton Walter Co. v. Village of Walton, 143 N. E. 786, 238 N. Y. 46, 50. Such expectancy may come from succession in place or name or otherwise to a business that has won the favor of its customers. It is then known as good will."

In the case at bar there was acceptance of the product by hospitals and physicians, and by a distributor who was ready and able to undertake its nationwide distribution and had, in fact, already undertaken it and paid in advance for a large initial order. [R. 45-46, 50.] That the good will for which petitioner paid existed is clear.

B. The Good Will Was Not Sold by Lewis to Petitioner Separately From the Business With Which It Was Connected.

The Tax Court next challenges Lewis' transfer of good will to petitioner on the ground that good will cannot be carved out of a business and sold independently of the going concern. [R. 52-53.] But an examination of the cases cited by the Tax Court on that point show clearly that the "going concern" which must also be transferred is limited to the business with which the good will is connected.

The good will here was not sold separately from the business with which it was connected. There is no finding that it was, and the record otherwise does not show that it was. The contrary is true.

Sales to one King under the label "Buoyant B" were discontinued as a condition of the deal with Hanisch, a condition agreed on before petitioner was formed. [R. 33-34, 50.] Sales under the name "Vitall" were never promoted and fell by the wayside because of trade-mark interferences. [R. 49-50, 108.] The only continuing promotion of the product was by way of the deal with Hanisch. When, on February 4, 1941, Lewis transferred the good will to petitioner, he transferred also manufacturing and formula rights in the products he had developed [R. 44-45], and also that deal with Hanisch, by formalizing the deal in the name of petitioner instead of in his own. [R. 34.] He transferred all this to petitioner as a "package" deal. [R. 103-105, 106-107.]

That "package" was the sum total of his vitamin business at that time, so that when he transferred the good will to petitioner, he also transferred the business with which it was connected. The fact that the parts of this "package" deal were represented by separate documents is of course unimportant; they are still one deal. (*Helvering v. Le Gierse et al.,* 312 U. S. 531, 540-541, 61 S. Ct. 646 (1941).) Lewis even transferred himself to petitioner, for he became petitioner's executive vice-president, treasurer, managing director, and sales manager, working an average of 12 hours per day. [R. 37, 98.] The record fails to show that he reserved even the slightest part of the business to himself or continued any business as an individual. The fact that on February 4, 1941, Lewis's entire vitamin business was tied up with Hanisch does not make it any the less a "going business," as the Tax Court used that term. [R. 53.]

The "package" consisting of the good will and the business with which it was connected, the business tied

up in the deal with Hanisch, was, as the Tax Court found, in existence before petitioner was formed [R. 33]; and petitioner was formed for the very purpose of taking it over. [R. 103-105.] The good will was not carved out and sold to petitioner separately; it was sold to petitioner with the business with which it was connected.

C. The Good Will Which Lewis Conveyed to Petitioner, as a Matter of Fact, and Necessarily as a Matter of Law, Passed to The Stuart Company With the Trade-mark "The Stuart Formula" to Which It Had Become Attached.

The good will which Lewis conveyed to petitioner attached itself to and became a part of the trade-mark "The Stuart Formula." The record shows this as a fact. [R. 112.] It is also a matter of law. In *Coca-Cola Bottling Co. v. Coca-Cola Co.*, 269 Fed. 796 (D. C. Del., 1920), the court, citing Hopkins on Trade-Marks (3rd Ed.), page 227, and Nims on Unfair Competition (2nd Ed.), Section 15, stated:

> "Trade-marks and the good will of a business are inseparable. In fact, a trade-mark is merely one of the visible mediums by which the good will is identified, bought, and sold, and known to the public."

Indeed, a trade-mark has no existence as property without the good will of the business in connection with which it is used. It cannot be sold without it. (*E. F. Prichard Co. v. Consumers Brewing Co.* (C. A. 6), 136 F. 2d 512, cert. den. 321 U. S. 763 (1944); *Walgreen Drug Stores v. Obear Nester Glass Co.* (C. A. 8), 113 F. 2d

956, cert. den. 311 U. S. 708, 311 U. S. 730 (1940); *Esso, Inc. v. Standard Oil Co.* (C. A. 8), 98 F. 2d 1 (1938); *U. S. Ozone Co. v. U. S. Ozone Co. of America* (C. A. 7), 62 F. 2d 881 (1932); *Joheph Schlitz Brewing Co. v. Houston Ice & Brewing Co.* (C. A. 5), 241 Fed. 817, aff'd 250 U. S. 28 (1919).) It is clear that, regardless of any intention of the parties, the good will which Lewis sold to petitioner became fused into the trade-mark "The Stuart Formula" and passed with it when that trade-mark was sold to The Stuart Company.

The fact is equally clear that what was expressly sold by petitioner to The Stuart Company was the trade-mark *and* good will. Under the contract of November 28, 1942, the trade-mark was transferred and petitioner required to execute "appropriate assignments," if requested. [R. 65.] Subsequently The Stuart Company requested the execution of an assignment, enclosing a form for that purpose [R. 110], and pursuant thereto petitioner assigned to The Stuart Company the trade-mark "The Stuart Formula" and the "good will of the business directly connected with the use of said trade-mark." [R. 110-111.]

There can be no doubt, therefore, that what was sold by petitioner to The Stuart Company under the agreement of November 28, 1942, included the good will connected with the products Lewis had developed, and that of necessity included the good will, connected with those products, which Lewis transferred to petitioner on February 4, 1941.

D. The Trade-mark "The Stuart Formula" Did Not Acquire Its Value Entirely From the Promotion and Sale of the Product by The Stuart Company; The Stuart Company Only Helped to Develop the Good Will Which Lewis Had Conveyed to Petitioner, and Petitioner's Ownership of That Good Will Was Not Affected by Such Development.

The Tax Court states in its opinion that the trade-mark "The Stuart Formula" acquired its value from the promotion and sale of the product under that name by The Stuart Company. [R. 53.] There is no finding or other part of the record to support that proposition. True, all of the advertising was paid for by Stuart. But Lewis, petitioner's executive vice-president, served also as an officer of Stuart without compensation. [R. 59, 99.] He actually guided and directed the advertising and, in fact, the entire promotion program. [R. 107-108, 157-158, 161.] The mere fact that Stuart paid the advertising bills does not detract from the fact that the trade-mark "The Stuart Formula" derived its life blood from the good will which Lewis had conveyed to petitioner.

Stuart, moreover, represented itself to the trade as distributor only. [R. 96.] If Stuart helped to develop this good will, it was still the good will of petitioner; for the good will which a distributor *acting and representing itself as such* develops belongs to the manufacturer. (*Lawrence-Williams Co. v. Societe Enfants Gombault et cie* (C. A. 6), 22 F. 2d 512 (1927).)

E. The Cost of the Good Will to Petitioner Must Be Deducted in Arriving at the Amount Includable in Gross Income in Respect of the Sale of the Good Will and Trade-mark to The Stuart Company; for Only the Gain Is Subject to Tax.

Good will is itself a capital asset. (*Ensley Bank & Trust Co. v. United States* (C. A. 5), 154 F. 2d 968, cert. den. 329 U. S. 732 (1946).) The cost to petitioner of the good will which it sold with the trade-mark to The Stuart Company is shown by the findings. [R. 45.] The statute is clear that only the excess of the amount realized over the cost is gain, and that only the gain may be taxed. (I. R. C. 1939, Secs. 111(a), 113(a), 113(b); App. herein, p. 1.)

It is not a question of whether the cost should have been incurred. It was actually incurred and that is enough. Even if it were illegally incurred this would still be true, since the tax is imposed only on the gain, not on the gross receipts. *Hofferbert v. Anderson Oldsmobile, Inc.* (C. A. 4), 197 F. 2d 504 (1952), citing several decisions of the Supreme Court, including *Goodrich v. Edwards,* 255 U. S. 527 (1921), where the court stated, at page 535:

> "It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that *gains* are derived therefrom by the vendor." (Italics in original.)

(To the same effect, *Commissioner v. Weisman et al.* (C. A. 1), 197 F. 2d 221 (1952); *Commissioner v. Guminski* (C. A. 5), 198 F. 2d 265 (1952); *Jones v. Herber* (C. A. 10), 198 F. 2d 544 (1952).)

It follows of necessity that the cost of the good will to petitioner must be deducted in arriving at the amount to be included in gross income in respect of the sale by petitioner of good will and trade-mark to The Stuart Company.

III.

The Commissioner Failed to Carry His Burden of Proof, Under the Tax Court Rules, in Respect to the Portion of the Good Will Cost Allowed in the Deficiency Notice but Disallowed by the Tax Court Upon Request of the Commissioner in an Amended Answer.

In the deficiency notice the Commissioner allowed one-fourth of the actual cost of the good will, or $19,585.24. By amended answer he asked the Tax Court to disallow that amount also. [R. 25, 49.] The Tax Court did so. [R. 53.] Under the Rules of Practice Before the Tax Court, Rule 32 (App. herein, p. 2), the burden of proof on an issue so raised is on the Commissioner. There is no finding here showing that the Commissioner carried that burden of proof or any finding showing that the petitioner made that proof for him. There is no finding that the good will and trade-mark had no cost or other basis. Even in the opinion there is no affirmative statement to that effect. The Tax Court's sole approach on this issue is wholly negative, as follows:

> "we find nothing to indicate" [R. 51],
> "the record fails to show" [R. 52, in two places],
> "Nor does the record indicate" [R. 52],
> "neither the bill of sale nor other evidence of record indicates." [R. 52.]

Clearly there must be proof, whether by one party or the other, to sustain a burden of proof. The mere absence of proof cannot do this. (*Roybark et al. v. United States* (C. A. 9), 218 F. 2d 164 (1955).)

It follows that the Tax Court erred in disallowing the amount of $19,585.24 which the Commissioner had allowed in his deficiency notice as cost of the good will and trade-mark sold to The Stuart Company.

By taking this position petitioner does not suggest that the amount of $19,585.24, being only one-fourth of the actual amount of $78,340.95, is the correct amount to be allowed as cost of the good will and trade-mark sold to The Stuart Company. Petitioner's position here is only that in the absence of proof no cost can be disallowed which was allowed in the deficiency notice.

IV.

The Entire Amount Received From the Stuart Company Under the Settlement Agreement of November 28, 1942, Was the Proceeds of the Sale of Good Will and Trade-Mark to That Company; No Part of It Was Ordinary Income.

A. No Part of the Consideration of $200,000 Received by Petitioner Under the Settlement Agreement of November 28, 1942, Is Allocable to Cancellation of the May 5, 1941 Distributorship Agreement, for the Reason That That Agreement Had Previously Been Cancelled and Was No Longer in Effect.

The question here is whether out of the total of $200,000.00 petitioner received from The Stuart Company under the contract dated November 28, 1942, the sum of $75,000.00 was ordinary income or capital gain.

That sum was capital gain if it was paid for property. (I. R. C., Sec. 117(a); App. herein, p. 2.) The Tax Court states that it was ordinary income instead because it was paid for the cancellation of a contract. [R. 73.] The contract referred to is the contract of May 5, 1941, under which petitioner as owner of the trade-mark "The Stuart Formula" and as manufacturer of the product sold under that name granted to The Stuart Company the exclusive distributorship of that product. [R. 55-58.] Such exclusive distributorship was subject to cancellation by petitioner if Stuart did not meet specified quotas. [R. 56.] Stuart was not otherwise bound to any quotas or otherwise bound to make any purchases from petitioner. [R. 56-57.]

By October, 1942, various disagreements between petitioner and The Stuart Company had reached a stage of impasse. Stuart began to drag its sales in an attempt to force petitioner to give Hanisch a 50% interest in "The Stuart Formula" trade-mark and some shares of petitioner's stock. Petitioner refused both of those demands. [R. 59-60.] By letter dated October 8, 1942, petitioner notified Stuart that, because of failure of Stuart to meet its quotas under the May 5, 1941 contract, its exclusive distributorship under that contract was cancelled, effective at the expiration of 60 days. [R. 60-61.] The 60-day period was a period allowed Stuart under the May 5, 1941, contract to cure any such shortages. [R. 56-57.] In that letter of October 8, 1942, petitioner also stated:

> "In all other respects, the contract remains in full force and effect." [R. 61.]

On October 12, 1942, Stuart replied that it did not believe it could cure the shortages, that it accepted the no-

tice of cancellation, that it considered the entire contract cancelled and not just the exclusive distributorship, and that it would not recognize any attempt on petitioner's part to withdraw the notice of cancellation. [R. 61-62.]

Petitioner had added the sentence "In all other respects, the contract remains in full force and effect" only to protect its property rights in the trade-mark, because of the provision in the contract under which it was agreed that the trade-mark "The Stuart Formula" was and remained the property of petitioner. [R. 47, 113, 143-145.] It was petitioner's belief that its notice of cancellation cancelled petitioner's right to supply Stuart and Stuart's right and obligation to buy. [R. 144-145.] By its letter of October 12, 1942, Stuart expressly took the same view. [R. 62.]

Subsequent to that reply, on October 23, 1942, petitioner's directors ratified the notice letter of October 8, 1942. [R. 62-63.] Anticipating a struggle with Stuart over the cancellation, they also authorized petitioner's officers "to take any and all necessary further steps, including the prosecution or defense of any litigation that may ensue therefrom," and "to settle said litigation, and/or sell 'The Stuart Formula' trade-mark." [R. 62-63.] They gave the officers no authority to cancel any contract. The contract of May 5, 1941, had been cancelled and they ratified it. The only authority which they gave petitioner's officers was to prosecute or defend, and settle, any ensuing litigation, and to sell the trade-mark.

On November 25, 1942, petitioner filed a suit for injunction against Stuart, Hanisch and others. [R. 63.] In that suit petitioner alleged, and it was a fact, that Stuart was preparing, without the consent or approval of petitioner, to use petitioner's trade-mark "The Stuart

Formula" on products not manufactured by petitioner, and of quality inferior to those manufactured by petitioner. [R. 108-109, 114.] What petitioner sought in that suit was only to have Stuart enjoined from using that trade-mark on products not manufactured by petitioner. Petitioner sought no damages; it sought only protection of its property in the trade-mark. [R. 109, 114.]

A temporary restraining order was granted, and on November 28, 1942, the litigation was settled. It was settled, as well it could be, by a transfer of the trade-mark for consideration, from petitioner to The Stuart Company. [R. 65, par. 2; R. 110-111.] In other words, the officers of petitioner settled the litigation by exercising their alternative or additional authority to sell the trade-mark. Petitioner's officers had no authority at that point to cancel any contract of any kind.

It is true that in terms the settlement agreement of November 28, 1942, also cancelled the distributorship contract of May 5, 1941. [R. 65.] As stated, however, in *Helvering v. Tex-Penn Oil Co.*, 300 U. S. 481, 493 (1937), affirming the Third Circuit, which reversed the Tax Court, the validity of a finding "is to be tested by what in fact was done rather than by the mere form of words used in the writings employed." As also stated more recently in *Wilson Athletic Goods Manufacturing Company v. Commissioner* (C. A. 7), 222 F. 2d 355, 357 (1955), reversing the Tax Court:

> "But in tax matters we are not bound by the strict terms of the agreement; we must examine the circumstances to determine the actualities and may sustain or disregard the effect of a written provision, if to do so best serves the purposes of the tax statute."

The fact here is that the settlement agreement of November 28, 1942, did not cancel the May 5, 1941, distributorship contract because on November 28, 1942, that contract had already been cancelled. Technically or theoretically, termination of the May 5, 1941 contract was to become effective at the expiration of 60 days after October 8, 1942, or on December 7, 1942. No one can suppose, however, that Stuart would agree on November 28, 1942, to pay $75,000.00 to cancel a contract which petitioner could not prevent from dying anyway on December 7, 1942.

Respondent may contend that the words in petitioner's notice of cancellation, "In all other respects, the contract remains in full force and effect," served to keep the contract in part alive, despite Stuart's reply of October 12, 1942, accepting the notice and expressly treating it as a complete cancellation. However, it is clear, as a matter of law, that petitioner's notice did terminate the contract completely.

In *Harri Hoffmann v. John H. Pfingsten*, 260 Wis. 160, 50 N. W. 2d 369, 26 A. L. R. 2d 1131 (1951), there was involved an action for injunction and damages for breach of contract. The parties had entered into a contract intended to be permanent whereby the defendant who had invented a shoe dressing was to manufacture it and the plaintiff was to be sole distributor. The quantity to be furnished was stated as 25,000 bottles per month at the price of 15 cents per bottle. Sales not having reached the quantity anticipated, the contract was amended by eliminating the clause fixing the quantity to be furnished and raising the price to 16 cents per bottle. The parties agreed (26 A. L. R. 2d at p. 1134):

> "That said contract in all other respects shall remain in full force and effect."

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The court there conceded that there was mutuality of obligation in the original contract but observed that as the contract was amended plaintiff's only agreement was to refrain from handling competitive products. It was not required to handle defendant's products at all. For that reason the court held that the contract was lacking in mutuality and was therefore unenforceable. This case is thoroughly annotated in 26 A. L. R. 2d beginning at page 1139. All of the cases on that question are there cited, analyzed and classified. There is not a single case which dissents from the view of the *Hoffman* case that a contract is lacking in mutuality under the circumstances stated.

The situation here is identical. Here, also, there was a distribution contract. Here, also, by modification—here pursuant to the terms of the original contract—the exclusive feature was stricken out. It was only that feature which was made dependent upon purchase of a specified amount. [R. 56-57.] As a result, when that feature was stricken out, there was left no obligation on the part of Stuart to buy. As the evidence further shows there was no intention even that there remain an obligation on the part of Stuart to refrain from buying products from any company other than petitioner. [R. 144-145.] But, even if there was such an intention, it follows clearly under the *Hoffmann* case that that element alone does not give the contract, or what remained of the contract, mutuality, and for lack of mutuality the contract must necessarily fall. It follows then that The Stuart Company acted upon good advice when it wrote its letter of October 12, 1942, and informed petitioner that it regarded the contract as terminated. At the time of the settlement agreement on November 28, 1942, the contract of May 5,

1941, no longer had existence. Obviously a contract which does not exist cannot be cancelled.

B. No Part of the Amount Paid Petitioner Under the Settlement Agreement of November 28, 1942, Can Be Allocated to Cancellation of the Distributorship Contract of May 5, 1941, and Treated as Ordinary Income, Because the Sale of the Good Will and Trade-Mark to the Stuart Company Necessarily, as a Matter of Law, Carried Such Cancellation With It.

The Tax Court on this issue states its conclusion as follows:

> "Since the $75,000 was received by petitioner for the cancellation of its contract with Stuart, the amount is taxable as ordinary income." [R. 73.]

It is clear from that statement that the Tax Court has wholly misconceived the law. It cites two cases, *Roscoe v. Commissioner* (C. A. 5), 215 F. 2d 478 (1954), and *Commissioner v. Starr Bros., Inc.* (C. A. 2), 204 F. 2d 673 (1953). The *Roscoe* case involved nothing but a 10% commission paid in the guise of an increase in the price of stock. Of course, it was ordinary income. The *Starr Bros.* case involved compensation received by a distributor of certain products for termination of his distributorship, and nothing more. It neither involved nor effected a transfer of any asset.

The *Starr Bros.* case has now been limited to that situation. In that case the Second Circuit expressly admitted it was in direct conflict with the Tenth Circuit in *Jones v. Corbyn*, 186 F. 2d 450 (1951), and the Third Circuit in *Commissioner v. Golonsky*, 200 F. 2d 72, cert. denied 345 U. S. 939, 73 S. Ct. 830 (1953). In the *Jones*

case the Tenth Circuit held that the cancellation of an exclusive general agency insurance contract was a sale of the agency rights to the insurance company. The Court there said, at p. 453:

> "The fact that the suit ended in a compromise settlement does not change the nature of the recovery. The nature of the basic claim from which the amount is received is the determining factor."

In the *Golonsky* case the Third Circuit held that money received by a tenant for getting out of possession of leased premises and turning them over to the landlord before the expiration date of the lease were the proceeds of the sale of the lessee's rights to the landlord.

In *Commissioner v. Ray,* 210 F. 2d 390, cert. denied 348 U. S. 829, 75 S. Ct. 53 (1954), the Fifth Circuit joined the Third and agreed with the *Golonsky* case. Then the Second Circuit, distinguishing its own *Starr Bros.* case on its particular facts, joined the other circuits and expressly agreed with the *Golonsky* and *Ray* cases. *Commissioner v. McCue Bros. & Drummond, Inc.,* 210 F. 2d 752, cert. denied, 348 U. S. 829, 75 S. Ct. 53 (1954). The Court there expressly limited the point of the *Starr Bros.* case to a situation in which no *transfer of property rights* was involved or effected. Because of that result we do not challenge the *Starr Bros.* case. We have no need to.

That Circuit, the Second, has now given the principle of the *Golonsky* case its full meaning. In *Millinery Center Bldg. v. Commissioner,* 221 F. 2d 322 (1955), reversing 21 T. C. 817, it held that where a lessee for a fixed sum obtained cancellation and termination of an onerous lease and also title to the property no amount could be allocated to cancellation of the lease but the entire amount

represented the cost of acquiring a capital asset. The Court there stated, at page 323:

> "Whatever may be the case where a lease is cancelled without the purchase of a fee, we think that the situation here at hand consists of the acquisition of a definite and substantial property interest, so to be viewed for tax purposes."

and at page 324:

> "We reach this result whether or not the lease was in fact onerous to the taxpayer, as it contends;"

It is interesting in this connection to note that the Tax Court here also made reference to a decision of this Court, *Stuart Co. v. Commissioner,* 195 F. 2d 176 (1952), in which this Court affirmed the Tax Court solely because it could "not find that there was clear error in the Tax Court's findings of fact and opinion." That case involved The Stuart Company's side, the deduction side, of this same transaction between that company and petitioner. The Tax Court there, 9 T.C.M. 585, stated, at page 590:

> "It is well settled that payments made to secure relief from an onerous contract are deductible as ordinary and necessary business expenses under Section 23(a) of the Internal Revenue Code."

In support of that doctrine it cited three cases, only one of which involved a transfer of property, *Cleveland Allerton Hotel, Inc. v. Commissioner* (C. A. 6), 166 F. 2d 805 (1948). With the case of *Millinery Center Bldg. v. Commissioner, supra,* we have then come full circle; for the Second Circuit there stated, at page 323:

> "With this conclusion we are in agreement, despite the contrary opinion of the Sixth Circuit in *Cleveland Allerton Hotel v. Commissioner,* 6 Cir., 166 Fed. 2d 805."

Thus the doctrine that the cancellation of an onerous contract necessarily results in ordinary income, even if the effect of the cancellation is a transfer of property, has lost its sanctity. The logic of the *Millinery Center* case is clear. If a lessee and lessor make an agreement whereby (1) the lease is cancelled and (2) the fee is conveyed to the lessee, (1) is superfluous since it automatically follows from (2). *Erving v. Jas H. Goodman & Co. Bank,* 171 Cal. 559, 563, 153 P. 945 (1915). Likewise, if as here, an exclusive distributor acquires from the manufacturer the trade-mark under which the product is sold, "together with the good will of the business directly connected with the use of said trade-mark" [R. 111], he ceases to be a distributor and becomes the manufacturer, and this is true even if he retains the original manufacturer to produce the product. *Warner-Patterson Company v. U. S.,* 68 Ct. Cls. 237 (1929). The distributorship which he had acquired from the original manufacturer would then have merged with the trade-mark and, as a separate bundle of rights, ceased to exist. All of this follows also as a matter of simple logic. He who owns a trade-mark has no need to have also a distributorship, exclusive or otherwise; he already holds those rights.

It follows here that even if the distributorship agreement between petitioner and The Stuart Company were still in existence on November 28, 1942, and was in fact onerous to The Stuart Company, and was in fact terminated by the agreement of November 28, 1942, even so the consideration of $200,000.00 received by petitioner under that agreement must be allocated entirely to the trademark and good will which, pursuant to the terms of that agreement, petitioner assigned to The Stuart Company.

CONCLUSION.

Petitioner submits, in conclusion, that (1) the Tax Court had jurisdiction to determine the deduction allowable for the year ended October 31, 1942, for compensation of M. H. Lewis, (2) that the full amount paid him in that year should have been allowed, (3) that the full amount paid him in the year ended October 31, 1943, should have been allowed as deduction for that year, (4) that the basis of the good will and trade-mark sold to The Stuart Company on November 28, 1942, included the full amount paid by petitioner to M. H. Lewis for the good will conveyed by him to petitioner on February 4, 1941, (5) that the Commissioner failed to carry his burden of proof as to the portion of that amount which he allowed in the deficiency notice but later asked, by amended answer, to be disallowed, and (6) that the entire amount received by petitioner under the agreement with The Stuart Company dated November 28, 1942, represented the proceeds of sale of a capital asset and no part thereof was ordinary income.

Respectfully submitted,

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APPENDIX.

A. Extracts From the Internal Revenue Code of 1939.

SECTION 23. DEDUCTIONS FROM GROSS INCOME.

(a) EXPENSES.

(1) TRADE OR BUSINESS EXPENSES.

(A) IN GENERAL. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. . . .

SECTION 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS. The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

SECTION 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) BASIS (UNADJUSTED) OF PROPERTY. The basis of property shall be the cost of such property. . . .

SECTION 113(b).

ADJUSTED BASIS. The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

Section 117. Capital Gains and Losses.

(a) Definitions. As used in this chapter—

(1) Captal Assets. The term "capital assets" means property held by the taxpayer. . . .

Section 122. Net Operating Loss Deduction.

(b) Amount of Carry-Back and Carry-Over.

(1) Net Operating Loss Carry-Back.

(A) Loss for Taxable Year Beginning Before 1950. If for any taxable year beginning after December 31, 1941, and before January 1, 1950, the taxpayer has a net operating loss, such net operating loss shall be a net operating loss carry-back for each of the two preceding taxable years, except that the carry-back in the case of the first preceding taxable year shall be the excess, if any, of the amount of such net operating loss over the net income for the second preceding taxable year computed.

Section 272. Procedure in General.

(g) Jurisdiction Over Other Taxable Years. The Board in redetermining a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid.

B. Rules of Practice Before the Tax Court of the United States Rule 32—Burden of Proof.

The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent.